BEFORE THE DEPARTMENT OF REVENUE
OF THE STATE OF MONTANA

In the matter of the amendment of ARM 42.13.111, 42.13.802, 42.13.803, 42.13.804, 42.13.805, and 42.13.806 regarding distilleries	))))	NOTICE OF AMENDMENT

TO: All Concerned Persons

1. On December 12, 2013, the Department of Revenue published MAR Notice Number 42-2-903 pertaining to the public hearing on the proposed amendment of the above-stated rules at page 2298 of the 2013 Montana Administrative Register, Issue Number 23.

2. On January 13, 2014, a public hearing was held to consider the proposed amendments. John Iverson of the Montana Tavern Association (MTA), Neil Peterson of the Gaming Industry Association (GIA), John McKee of Headframe Spirits, and Bryan Schultz of RoughStock Distillery, all appeared and testified at the hearing. Mr. McKee and Mr. Schultz also submitted written comments. The department received written comments from Robin Blazer of Willie's Distillery, Jim Harris of Bozeman Spirits Distillery, Mark Hlebichuk of MT Distillery, Casey McGowan of Trailhead Spirits, Ryan Montgomery of Montgomery Distillery, Lauren Oscilowski of Glacier Distilling Company, and Brady Wiseman, sponsor of House Bill 517, L. 2005.

3. The department has amended ARM 42.13.803 and 42.13.804 as proposed.

4. Based upon the comments received and after further review, the department has amended the following rules as proposed, but with the following changes from the original proposal, new matter underlined, deleted matter interlined:

42.13.111 DEFINITIONS (1) through (20) remain as proposed.

AUTH: 16-1-303, 16-1-424, ~~16-9-1009~~ 16-4-1009, MCA
IMP: 16-1-424, 16-3-302, 16-3-311, 16-4-312, 16-4-404, 16-4-406, 16-4-1001, 16-4-1002, 16-4-1003, 16-4-1004, 16-4-1005, 16-4-1006, 16-4-1007, 16-4-1008, 16-6-104, MCA

42.13.802 DOMESTIC DISTILLERIES (1) and (2) remain as proposed.
(3) Upon approval by the department, a domestic distillery licensee may own, lease, maintain, and operate a non-contiguous warehouse for the sole purpose of storing liquor. To seek approval, the licensee shall submit a form provided by the department and include:
(a) verification that the Alcohol and Tobacco Tax and Trade Bureau approved the licensee's registration to operate the warehouse;

(b) verification that local building, health, and fire officials approved the warehouse for its intended use; and

(c) proof of complete control over and possessory interest in the land and warehouse.

(3) and (4) remain as proposed, but are renumbered (4) and (5).

42.13.805 MICRODISTILLERY SAMPLE ROOMS (1) and (2) remain as proposed.

(3) All liquor products provided to a consumer for on- or off-premises consumption in the sample room must have been produced at the microdistillery. For a product to be considered as having been produced at the microdistillery, the following criteria must be met:

(a) as measured by proof gallons on a ~~monthly~~ quarterly basis, at least 90 percent of the aggregate amount of liquor provided for on- and off-premises consumption in the sample room must have been distilled at the microdistillery; and

(b) remains as proposed.

(4) Any microdistillery that is licensed and has a department-approved sample room as of ~~March 1, 2014~~ May 9, 2014, has until October 1, 2015, to come into compliance with (3)(a). Any such microdistillery that does not meet (3)(a) shall, at a minimum, maintain the percentage it has as of ~~March 1, 2014~~ May 9, 2014, until October 1, 2015.

(5) remains as proposed.

(6) To provide a liquor product in a microdistillery sample room, the licensee must obtain either a certificate of label approval or an exemption from label approval from the Alcohol and Tobacco Tax and Trade Bureau.

(7) Regardless of the liquor's alcohol content, a licensee is only permitted to provide not more than 2 ounces of the liquor product approved in (6) for on-premises consumption per individual during a business day.

(6) and (7) remain as proposed, but are renumbered (8) and (9).

42.13.806 USE OF OUTSOURCED DISTILLED SPIRITS IN THE MANUFACTURING OF DISTILLED SPIRITS (1) A distillery licensed by the department and located in Montana may ~~import~~ procure bulk distilled spirits from another distilled spirits plant by requesting such products through the department on a form supplied by the department. The distillery may only use the acquired distilled spirits:

(a) and (b) remain as proposed.

(2) through (5) remain as proposed.

5. The department has thoroughly considered the comments and testimony received. A summary of the comments received and the department's responses are as follows:

COMMENT NO. 1: The department received the following comments regarding the proposed definition in ARM 42.13.111(5) of the term "distilled at the microdistillery."

Mr. Iverson testified that the MTA generally stands in support of the proposed

rules and believes they clarify the existing law and clearly communicate to the industry that the special privileges given to microdistilleries are given for those microdistilleries that are "producing the product." And by "producing the product" he stated that he meant that the microdistilleries were both distilling and crafting the product by adding to it to make blends. The law gives those distillers that are crafting a Montana-made product the opportunity to showcase their special products. These privileges were never intended to be a work-around of the licensing system or to allow showcasing product that the microdistillery is not crafting.

Mr. Iverson commented that he would like the department to tighten up ARM 42.13.111(5). Section (5) defines "distilled at microdistillery" to mean the process of vaporization and subsequent condensation of a beverage containing ethyl alcohol that occurs at the licensed premises. Mr. Iverson would like that definition to state "to be considered as distilled at the microdistillery, a product may not have been previously distilled at another distilled spirits plant." Mr. Iverson stated that this will require microdistilleries that sell booze to actually make the booze and prevent buying a pre-made product, reprocessing it, and calling it their own. This is outside of the intent of the law, and outside of what most Montana consumers expect when they are purchasing a product that they believe is a Montana craft product.

Mr. Iverson commented that the industry was sold to the public as a value-add to Montana agriculture products. It was one of the big selling points of this special set-up created for microdistilleries. Bringing in sourced, neutral-grain spirits, that may primarily be from the Midwest, is not a value-add to Montana agriculture products. Further amending the definition will clarify the intent of the law in the administrative rules to make it clear that those special privileges are allowed only to those that are essentially doing grain-to-bottle distilling.

Mr. Peterson testified that the reason the GIA has an interest in the rules is because an on-premises liquor license is required for an establishment to have a gaming license in Montana. Mr. Peterson further stated that he is generally in support of the rules, but agrees with Mr. Iverson's comments.

Mr. Harris commented that he does not agree with Mr. Iverson's proposed definition because it is more restrictive than the actual statute and no reasonable purpose or cause was given to support a rule that is more restrictive than the statute. As a microdistillery, there are processes that may require using products made outside of the distillery, such as low wines, crèmes and flavoring components. Mr. Harris also commented on Mr. Iverson's testimony that the microdistillery is required to use only Montana products to manufacture or produce alcohol and that the original sample/tasting room was allowed for the reason that it would provide a Montana product that was produced using only Montana grains and/or agricultural products. Mr. Harris stated that this is not the case and that he disagrees with that testimony. Value-add for agriculture was a benefit of the entire bill, not isolated to the tasting room. No purpose or cause is given to make this restriction by rule above and beyond the statute itself.

Mr. McKee commented that he is concerned that Mr. Iverson made partially misleading statements at the hearing by indicating that the privilege to operate a distillery in Montana is predicated upon grain-to-bottle distillation using Montana grains. Mr. McKee stated that he can find no such distinction in any section of Title 16 of the MCA. Furthermore, if considered as true, there would be a deleterious

effect on many different distilleries in Montana that do not use Montana-sourced grains. If added as an amendment to the regulations, some distilleries would be forced to discontinue certain product lines. For example, RoughStock Distillery would be forced to cease production of its bourbon product because its corn is not grown in Montana and Whistling Andy's would be forced to cease production of their various rum products because rum is not made from grain. Mr. McKee further commented that Mr. Iverson's proposal to change the definition would preclude Montana distilleries from producing spirits that contain raw ingredients with material distilled elsewhere. By way of example, Mr. McKee stated that Mr. Iverson's definition would shut down his production of crème liquor because he did not produce the cream used to stabilize the product.

Ms. Oscilowski commented that she sees no need for the language to change as it currently reads the same as the federal Alcohol and Tobacco Tax and Trade Bureau (TTB) definition for distilled spirits.

RESPONSE NO. 1: The department appreciates these comments from the industry. The term "distilled at the microdistillery," as amended in ARM 42.13.805, requires at least 90 percent of the aggregate amount of liquor provided for on- or off-premises consumption in the sample room to have been distilled at the microdistillery.

Sections 16-1-401 and 16-1-404, MCA, permit the importation and use of bulk distilled spirits by a licensed distillery or microdistillery. Further amending the term "distilled at the microdistillery" to prohibit a product from having been previously distilled elsewhere, is impermissible because the administrative rule would impose requirements more restrictive than the statutes. Therefore, no further amendments are being made to the definition at this time.

As background information, House Bill 517, adopted by the 2005 Legislature, allowed for the issuance of a distillery license and prescribed the allowable functions that may be performed by a Montana distillery. Later, the 2011 Legislature adopted Senate Bill 215, which provided for a reduced markup for distilleries that use certain percentages of Montana-produced ingredients. Neither bill required Montana distilleries to adopt a grain-to-bottle concept for all of the products they manufacture.

COMMENT NO. 2: The department received comments regarding the premises suitability requirements for product storage in ARM 42.13.802 from Ms. Blazer, Mr. Harris, Mr. Hlebichuk, Mr. McGowan, Mr. McKee, Mr. Montgomery, Ms. Oscilowski, Mr. Schultz, and Mr. Wiseman. The following is a combined summary of their comments.

Alcohol manufacturing is overseen at the federal level by the TTB of the United States Department of the Treasury. The TTB routinely allows distilleries to bond non-contiguous premises within a ten-mile radius of the distilled spirits plant (DSP), to allow for off-site storage of bonded spirits. The TTB allows these non-contiguous storage operations under a single area bond. In addition, the TTB gives its agents latitude to allow for an even larger area to be covered under an area bond.

This is important to domestic distilleries in Montana because such distilleries commonly start out with a relatively small bonded space and soon require more bonded storage than is available on the original premises. Making whiskey or

brandy requires that spirits be stored in oak barrels which consume a good deal of space. As a quickly growing business, storage space is at a premium. Continuing growth of distilleries requires continuing growth of bonded storage space which is typically unavailable in the original bonded DSP premises.

The rule, as proposed, causes direct economic harm to the industry by severely restricting the physical growth of two-thirds of Montana's distilling enterprises. In order for some distilleries to expand under the proposed regulation, it would be necessary to purchase adjacent property in very expensive urban/commercial districts, properties that very often are not available for sale. Buying contiguous buildings in some locales is not always possible, either from an economic standpoint or because the building next door is not for sale.

The department's proposed language is contravened by 16-4-312(1)(c), MCA, which provides that a distillery located in Montana and licensed pursuant to 16-4-311, MCA, may perform those "operations that are permitted for bonded distillery premises under applicable regulations of the United States department of the treasury." The commenters contend this includes the storage of spirits in non-contiguous bonded storage space. The department's proposed rule creates a new, more restrictive regulation under state rule-making than is implemented by the TTB under federal law and is in direct contradiction to statute.

One commenter stated that he presumes that the purpose of the rule is ultimately to assist in controlling the taxation of alcohol, and added that as the second most regulated industry in the nation, the TTB has this well in hand. Every bit of bonded space used is thoroughly vetted by the federal government, along with the movement and control of alcohol, and its proper taxation.

The commenters request that the department recognize that its proposed rule does not comport with Montana statute and reconsider this proposal and comply with 16-4-312, MCA, by harmonizing its premises requirements with those of the TTB. The department should recognize and permit all bonded distillery premises as permitted by the TTB. This will bring the department's proposed rules into compliance with the statute and give Montana's distillers one set of rules to comply with regarding bonded premises, instead of two.

RESPONSE NO. 2: The department would like to thank the industry for its comments on this issue. The rule has been amended to allow a domestic distillery licensee to seek department approval to have a non-contiguous warehouse for liquor storage, in compliance with the premises requirements of the TTB.

COMMENT NO. 3: The department also received comments regarding the requirement in ARM 42.13.805(3)(a) that 90 percent of the aggregate amount of liquor provided for on- and off-premises consumption in the sample room be distilled at the microdistillery.

Ms. Blazer proposed that the department change the percentage from 90 to 50. She explained that high-proof alcohol is widely used in craft distilleries and is a well-accepted method of producing a hand-crafted product. For example, high-proof neutral alcohol is used in their chokecherry liqueur. They would not be able to replicate this high-proof neutral tasting spirit in their current production equipment because it is specially made for whiskey, brandy, and aromatic vapor-based spirits.

If forced to use a distilled spirit made entirely on-site in order to continue producing a niche Montana product that is popular, but not a large income item, would require an equipment purchase of more than $200,000, which is the real cost of a still with the ability to produce a high-proof neutral alcohol. The other choice would be to discontinue the product. Ms. Blazer submitted that using an alcohol base distilled at a different distillery makes it no less their product. Their method of producing the liqueur drastically alters the original character of the distilled neutral spirit and maintains the original intent of the law.

Ms. Blazer further commented that tracking the aggregate percentage of on-premises distilled spirits will be extremely difficult. The department is proposing that a growing business with a wide variety of products in the tasting room accurately predict the sales of the aggregate of products. Hypothetically, a very popular spirit could hit the threshold of allowed monthly sales after only a few days into the month. Does the department propose that a distillery shall not offer for sale a product that is a very good revenue generator in favor of selling more of a product that may not generate as much revenue for the business? For example, if a distillery sells products A, B, and C, and product A causes the distillery to hit the 90 percent (or her proposed 50 percent) aggregate threshold in the first week of the month, it must be pulled from the shelf.

Ms. Blazer stated that if the sales in Montana are not as strong as needed due to the restriction of the number of allowed salespeople, a large amount of revenue will certainly be lost. In addition to being impossible to track and predict, it unfairly retards the growth of the industry. The forecasted calculations of revenue lost due to this ambiguous aggregate amount are enough to cause their tasting room to freeze hiring of additional employees in the summer months. Ms. Blazer stated that they cannot predict what the consumer wants to sample. Their tasting room allows them to expand into new markets by word of mouth that otherwise would be impossible to reach with their limited budget. It has allowed them to expand into three other states that otherwise would not be carrying their products, based on referrals from people who visited the tasting room and requested the product at their local liquor store.

Mr. Schultz testified that he is generally a proponent of the proposed rule changes, with the exception of (3)(a). He proposed that the department change it from 90 to 100 percent. Mr. Schultz stated that a percentage lower than 100 percent conflicts with 16-4-310, MCA, which requires everything to be made on premises.

RESPONSE NO. 3: The department appreciates these comments. Ms. Blazer recommends reducing the percentage to 50 percent and Mr. Schultz recommends increasing it to 100 percent. These different perspectives from the commenters provide a good example of why the department determined the need to amend the rule as proposed.

As explained at the hearing and provided in the reasonable necessity statement, the amendments were an effort to address an ambiguity in the law. The ambiguity exists because 16-4-310, MCA, defines "produces" as the distillation of liquor occurring on the premises of the microdistillery, while 16-1-401 and 16-1-404, MCA, allow for the importation of bulk distilled spirits for use by a microdistillery.

Based on these potentially conflicting statutory provisions, the department has determined that it is reasonable to allow a microdistillery to use a certain percentage of product acquired from another distilled spirits plant. The department concluded that allowing up to 10 percent of the product to come from an outside source would not compromise the authenticity of the Montana-made products sold by the industry.

The department also understands that tracking percentages and predicting sales on a monthly basis may present challenges to licensees. The department is further amending ARM 42.13.805 to reduce the reporting to a quarterly requirement to allow the distillers additional time to monitor their sales.

COMMENT NO. 4: The department received the following comments regarding the requirement in ARM 42.13.805(4) that any microdistillery that is licensed and has a department-approved sample room as of March 1, 2014, come into compliance with ARM 42.13.805(3)(a) by October 1, 2015.

Ms. Blazer stated that she agrees that the October 1, 2015 compliance deadline is sufficient and should be seamless for most distilleries to comply with. However, Ms. Blazer disagreed with the inclusion of the March 1, 2014, date because the rule then allows existing microdisilleries until October 1, 2015, to come into compliance but requires microdistilleries established after March 1, 2014, to be in immediate compliance. This gives fully developed businesses an unfair advantage. Removing the March 1, 2014, date will afford all microdistilleries until October 1, 2015, to come into compliance, which ensures a level playing field, eliminates one business receiving preferential treatment over another, and affords equal protection under the law.

Mr. Harris commented that he is not in favor of the proposed language and feels that the first sentence in (4) should be removed. He is not in agreement with setting a date of March 1, 2014, and proposed a date of March 1, 2015, instead.

Ms. Oscilowski commented that she would like to see the March 1, 2014, date stricken and allow all distilleries an equal opportunity to come into compliance by October 1, 2015. This would provide all DSPs the same amount of time to come into compliance regardless of their current aggregate percentage of liquor distilled at the microdistillery. Furthermore, this arbitrary date does not allow distilleries the opportunity to work through inventory that is not currently in distribution and provides an unfair advantage to those DSPs that already have product in distribution.

Mr. Schultz commented that he disagrees with the October 1, 2015, date and proposed changing it to October 1, 2014. He explained that the 2015 compliance date is very lengthy and creates consumer confusion, whereas the 2014 date would give all licensees more than enough time to deplete stocks, change sales strategies, rebrand, discontinue, or otherwise dispose of materials and products that are in violation.

Mr. Wiseman commented that he objects to the date provisions because it creates a two-tier system among microdistilleries, with an unfair advantage for distilleries that can qualify with this proposed rule. Distilleries that do not qualify are not being afforded equal protection under the law. Given the dynamic nature of this new industry, the department is certainly aware that a number of new distilleries have recently come on line and that a significant number will come on line before

October 1, 2015. Freezing the status quo as of March 1, 2014, and then allowing a full 18 months for compliance, creates a seriously tilted playing field in favor of the incumbents. New distilleries are typically fast growing businesses.

Mr. Wiseman stated that this proposed rule will allow existing distilleries to grow, but prevent newer distilleries from growing by engaging in exactly the same business activities. He requested that the department revise this proposed rule to allow all distilleries the same opportunity to engage in the same business activities. Given the 18-month compliance period, he suggests that the qualification date of March 1, 2014, be set back by one full year to March 1, 2015. This will create a far more equitable environment for all distilleries, rather than privileging a few to engage in business activities that are denied to others.

RESPONSE NO. 4: The department appreciates the comments addressing this issue. After careful consideration, the department determined not to alter the dates in the proposed rule based on the comments submitted. The department is, however, changing the March 1, 2014, date based on the time of rule adoption. The department has amended the requirement in ARM 42.13.805(4) so that compliance by October 1, 2015, is required for any microdistillery that is licensed and has a department-approved sample room as of May 9, 2014, rather than March 1, 2014. Additionally, a microdistillery is required to at least maintain the percentage it has as of May 9, 2014.

The department would like to address why it did not respond by altering the dates provided in the proposed rule based on the comments provided. First, the department found that altering the compliance deadline from October 1, 2015, to October 1, 2014, would not afford existing distilleries sufficient time to make any necessary adjustments to their business models. Second, the department found that extending the March 1, 2014, date (now amended to May 9, 2014) beyond the rule adoption date, would allow for newly licensed distilleries to enter the market and potentially be immediately out of compliance. While the department sought to afford existing distilleries time to make necessary adjustments, new license applicants can be expected to enter the market with a business model that appropriately accounted for the requirement in ARM 42.13.805(3)(a). Finally, the department believes that distilleries should at least maintain their aggregate percentage from the date of rule adoption until October 1, 2015, to help ensure progress towards a compliant percentage.

COMMENT NO. 5: Ms. Blazer commented that the use of the word "import" in ARM 42.13.806(1) eliminates the possibility of sourcing distilled spirits from another distillery located in Montana, and proposed striking this word.

RESPONSE NO. 5: The department appreciates Ms. Blazer's comment and agrees with her concern. ARM 42.13.806 is being further amended to address this issue by changing the word "import" to "procure," thereby allowing a distillery to acquire bulk spirits from plants located inside or outside of Montana.

6. An electronic copy of this notice is available on the department's web site, revenue.mt.gov. Select the Administrative Rules link under the Other Resources

section located in the body of the homepage and open the Adoption Notices section within. The department strives to make the electronic copy of this notice conform to the official version of the notice, as printed in the Montana Administrative Register, but advises all concerned persons that in the event of a discrepancy between the official printed text of the notice and the electronic version of the notice, only the official printed text will be considered. While the department also strives to keep its web site accessible at all times, in some instances it may be temporarily unavailable due to system maintenance or technical problems.

/s/ Laurie Logan
LAURIE LOGAN
Rule Reviewer

/s/ Mike Kadas
MIKE KADAS
Director of Revenue

Certified to the Secretary of State on April 28, 2014